



STATE OF WASHINGTON

## OFFICE OF FINANCIAL MANAGEMENT

*Insurance Building, PO Box 43113 • Olympia, Washington 98504-3113 • (360) 902-0555*

December 19, 2003

**The Honorable Gary Locke, Governor**  
**Citizens of the State**  
**Members of the Fifty-Eighth Legislature**  
State of Washington  
Olympia, Washington 98504

In accordance with Chapter 43.88.027 of the Revised Code of Washington, the Office of Financial Management has prepared this Comprehensive Annual Financial Report (CAFR) of the state of Washington for the fiscal year that ended June 30, 2003. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the state. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the various funds and subsidiary accounts of the state. All disclosures necessary to enable the reader to gain an understanding of the state's financial activities have been included.

The report is presented in three sections: Introductory, Financial, and Statistical. The Introductory Section includes this transmittal letter. The Financial Section begins with the independent auditor's report and contains management's discussion and analysis (MD&A), government-wide financial statements, fund financial statements, notes to the financial statements, required supplementary information, combining financial statements, and schedules. This letter of transmittal is designed to compliment the MD&A, which presents a narrative introduction, overview, and analysis of the financial statements. The Statistical Section includes selected financial, economic, and demographic data.

The state provides a wide range of services. These include education, social, health, transportation, environmental, law, public safety, resource and recreation development, public improvement, and general administrative services. The accompanying report includes all funds and subsidiary accounts of the primary government, the state of Washington as legally defined, as well as all of its component units. Component units are legally separate entities for which the primary government is financially accountable. The determination of "financial accountability" is based on criteria established in Governmental Accounting Standards Board Statement No. 14. Note 1.A to the financial statements explains more fully which organizations are included in the reporting entity.

### **Profile of Washington State**

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The state of Washington was created by an enabling act of Congress in 1889. The state is located on the Pacific Coast in the northwestern corner of the continental United States. Washington

comprises 68,139 square miles and currently has a population of 5.8 million. Washington is famous for its scenery of breathtaking beauty and sharp contrasts. On the west side of the state, high mountains rise above coastal waters. The forests of the Olympic Peninsula are among the rainiest places in the world. Washington's coastline has hundreds of bays and inlets that make excellent harbors. In the eastern part of the state, the flat semi-desert land stretches for long distances without a single tree.

Washington's location makes it a gateway for land, sea, and air travel to Alaska and the Pacific Rim countries. Ships from all parts of the world dock at Washington ports. The Boeing Company, a leading producer of commercial airliners and spacecraft, has plants in Auburn, Kent, Renton, Everett, and Spokane. Microsoft, a leader in the computer software industry, makes its home in Redmond. The Weyerhaeuser Company, a major producer of wood and related products, is headquartered in Federal Way. Costco Wholesale Corporation, headquartered in Issaquah, operates an international chain of membership warehouses.

East of the Cascade Mountain Range, farmers raise livestock and wheat on large ranches. Washington leads the nation in apple production. The state produces large amounts of lumber, pulp, paper, and other wood products. The mild moist climate in western Washington makes the region excellent for dairy farming and the production of flower bulbs.

## **Governmental Structure**

As established in the State Constitution, the state consists of three branches of government: the Executive Branch, the Legislative Branch, and the Judicial Branch. The Executive Branch has nine elected officials as follows: the Governor, Lieutenant Governor, Secretary of State, State Treasurer, State Auditor, Attorney General, Superintendent of Public Instruction, Commissioner of Public Lands, and Insurance Commissioner. Forty agency heads are appointed by, and report to, the Governor. Eighty-eight agency heads report to a board appointed in whole or in part by the Governor. The Legislative Branch consists of two legislative bodies: the Senate consisting of 49 members, and the House of Representatives with 98 members. The Judicial Branch consists of the State Supreme Court that is the highest court in the state comprised of nine Justices. Every two years, three Justices are elected for six-year terms. A Chief Justice is chosen from among the most senior Justices.

## **Washington State's Economy and Revenue Outlook**

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The National Bureau of Economic Research determined that the end of the 2001 national recession occurred in November 2001. The recession lasted eight months, slightly less than average for recessions since World War II. However, the recovery is the longest without a sustained increase in employment in postwar history. Washington State has been affected in much the same way as the nation. Wage and salary employment in Washington State is not expected to regain its Fiscal Year 2001 peak until Fiscal Year 2005.

Even though Washington State's wage and salary employment stabilized in Fiscal Year 2003, it was still slightly lower than wage and salary employment in Fiscal Year 2002. Personal income grew at a more robust rate of 4.3 percent in Fiscal Year 2003. That performance was an improvement over the state's personal income growth of only 2.3 percent in Fiscal Year 2002. The aerospace industry continued its job layoffs into Fiscal Year 2003 with a decline of 15.3 percent. The recent recession hit other manufacturing employment hard in Washington as well as the rest of the U.S. Washington manufacturing employment excluding aerospace fell by 5.2 percent in Fiscal Year 2003. Fiscal Year 2003 will be the fifth fiscal year in a row that manufacturing employment

in Washington has declined. In Fiscal Year 2003, Washington's unemployment rate reached 7.2 percent. As recently as Fiscal Year 2000, the state's unemployment rate was below 5 percent. Washington continues to have one of the highest unemployment rates of all the states in the nation.

Washington's outlook anticipates recovery in Fiscal Year 2004 and slightly less than average growth in Fiscal Year 2005. Wage and salary employment in Washington is forecast to increase by only 0.1 percent in Fiscal Year 2004 but reach a more normal growth rate of 2.0 percent in Fiscal Year 2005. Personal income is expected to rebound sooner than employment, growing by 3.8 percent in Fiscal Year 2004 and 4.9 percent in Fiscal Year 2005. General Fund-State revenues are forecast to increase by 7.9 percent in the 2003-05 Biennium compared to a 0.6 percent decline in the 2001-03 Biennium due to the recession.

### **Economic Condition in Fiscal Year 2003**

Washington's wage and salary employment declined at the rate of 0.2 percent in Fiscal Year 2003, a smaller decline than the 0.5 percent fall in U.S. wage and salary employment. Washington wage and salary employment fell by more than 6,200 during Fiscal Year 2003. Personal income in Washington grew slightly faster than U.S. personal income, 4.3 percent in Washington compared to 3.1 percent for the U.S. Real per capita income growth was up in Washington by 2.4 percent over the same period as compared to only 1.2 percent for the nation as a whole.

Aerospace employment was a major factor in the year's slow employment growth. After adding more than 15,000 employees in Fiscal Year 1998, employment in the aerospace industry fell by a total of 28,200 in Fiscal Years 1999 through 2002. Aerospace employment continued its decline in Fiscal Year 2003, falling by 12,700. Just as the aerospace employment decline accelerated in Fiscal Year 2003, a host of other manufacturing industries also continued to decline. Manufacturing employment excluding aerospace in Washington declined by 11,400 jobs in Fiscal Year 2003, a reduction of 5.2 percent.

Employment in durable manufacturing other than aerospace fell by 6.4 percent in Fiscal Year 2003 (a decline of 8,200 jobs) while employment in durable manufacturing nationally declined by 8.0 percent. Employment increased in only two durable manufacturing industries in Washington during Fiscal Year 2003. Employment in electrical equipment, appliances, and components grew by 1.5 percent and employment in other transportation equipment (transportation equipment other than aerospace) increased by 0.7 percent. All other durable manufacturing sectors experienced declining employment. The smallest decrease (1.5 percent) occurred in wood products. Employment in other durable manufacturing fell by 2.3 percent while employment in fabricated metal products decreased by 3.3 percent in Fiscal Year 2003. Machinery manufacturing experienced declining employment at the rate of 9.1 percent during Fiscal Year 2003. The largest percentage declines occurred in the primary metals industry, down 20.0 percent (a decline of 1,500 jobs), and the computer and electronic products industry, down 14.3 percent (loss of 4,100 jobs). Non-durable manufacturing employment in Washington decreased by 2.1 percent in Fiscal Year 2003, a loss of 3,100 jobs. Nationally, non-durable manufacturing employment declined by 3.5 percent. In Washington, most non-durable manufacturing industries experienced employment losses in Fiscal Year 2003. The largest percentage losses in employment occurred in printing, a 7.2 percent decline, and paper and paper products, a 4.7 percent loss. Employment in petroleum products declined by 1.0 percent, and employment in food products decreased by 0.6 percent. Other nondurable manufacturing employment decreased by 5.9 percent.

Washington's non-manufacturing employment grew by 0.8 percent during Fiscal Year 2003, with construction employment growing by 0.8 percent, services employment increasing by 1.2 percent,

and employment in the financial activities industry rising at a rate of 2.0 percent. Government employment also increased with state and local government employment growing by 1.6 percent and federal government civilian employment increasing by 2.7 percent in Fiscal Year 2003. On the other hand, wholesale trade employment declined by 1.8 percent, retail trade employment fell by 0.2 percent, and transportation, warehousing, and utilities employment decreased by 1.6 percent.

## **Economic Outlook**

The economic forecast for Washington State for Fiscal Years 2004 and 2005 reflects the impact of the long-awaited recovery at both the state and national levels. According to the November 2003 forecast by the state Economic and Revenue Forecast Council, growth in Washington's wage and salary employment is predicted to increase by only 0.1 percent in Fiscal Year 2004 but return to growth of 2.0 percent in Fiscal Year 2005, a rate closer to the long-term average. Washington's employment performance is expected to be comparable to national growth rates for both of those fiscal years.

Washington's personal income growth is expected to rebound in Fiscal Years 2004 and 2005 with growth of 3.8 percent and 4.9 percent, respectively. However, Washington's personal income growth will lag slightly behind U.S. personal income growth, which is predicted to be 4.2 percent in Fiscal Year 2004 and 5.5 percent in Fiscal Year 2005. Slow recovery in the aerospace industry is a major factor affecting the state's personal income growth.

Manufacturing employment in Washington is projected to continue its decline in Fiscal Years 2004 and 2005. The current decline in aerospace employment is expected to carry forward into Fiscal Year 2004 with a further reduction of 12.2 percent, slowing to a decline of 4.0 percent in 2005. Other manufacturing sectors are expected to decline by about 3,400 jobs (1.7 percent decrease) in Fiscal Year 2004. However, growth is expected to return in Fiscal Year 2005 with an increase in manufacturing employment excluding aerospace of 0.5 percent in Fiscal Year 2005, an increase of about 1,000 jobs.

In the non-manufacturing sectors, the strongest growth is predicted to occur in the information sector. Information employment is forecast to start growing again with a small increase of 0.8 percent in Fiscal Year 2004 but then to rebound significantly with 6.1 percent growth in Fiscal Year 2005. Financial activities employment growth is expected to be another bright spot in the recovery. Employment in that sector should grow by a relatively robust 2.5 percent in Fiscal Year 2004, and continue that trend into Fiscal Year 2005 with growth of 2.3 percent.

Retail trade employment is forecast to show slightly positive growth of 0.7 percent in Fiscal Year 2004 and 0.9 percent growth in Fiscal Year 2005. Wholesale trade employment is expected to increase by 0.6 percent in Fiscal Year 2004 and rebound in a stronger way with 3.4 percent in Fiscal Year 2005. Construction employment should grow modestly with increases of 1.6 percent in Fiscal Year 2004 and 1.7 percent in Fiscal Year 2005. Employment growth in transportation, warehousing, and utilities employment is expected to have no growth in Fiscal Year 2004 but bounce back strongly with 4.3 percent growth in Fiscal Year 2005. Employment in the services industries is forecast to grow by 0.9 percent in Fiscal Year 2004 and 3.1 percent in Fiscal Year 2005.

Some Washington industries are predicted to continue to experience slow or no growth going into Fiscal Years 2004 and 2005. State and local government employment is expected to begin showing the impacts of serious budget cuts with a decline of 0.6 percent in Fiscal Year 2004 and a very modest increase of 0.5 percent in Fiscal Year 2005. Federal government civilian employment

is forecast to fall in Fiscal Year 2004, by 1.6 percent, and then grow slightly by 0.3 percent in Fiscal Years 2005. The worst growth performance among the non-manufacturing sectors is predicted to occur in the natural resources and mining industry. Employment in this industry is expected to fall by 7.8 percent in Fiscal Year 2004 and decline by 1.8 percent in Fiscal Year 2005.

## **General Fund-State Revenues**

General Fund-State revenues for the 2001-03 Biennium were \$21.1 billion, a decrease of 0.6 percent in nominal terms over the previous biennium. Without the effect of voter-approved initiatives and legislated tax cuts, which lowered taxes and diverted revenues from the General Fund, revenues would have grown by 1.9 percent in the 2001-03 Biennium.

Revenue growth is expected to rebound in the 2003-05 Biennium. General Fund-State collections are forecast to increase by 7.9 percent during that two-year period, generating revenue of \$22.8 billion. A series of revenue enhancements including the addition of more auditors to the Department of Revenue, an increase in fines and penalties related to delinquent taxes, and the delay of transfers of the state property tax to local school districts to reduce class sizes, helped buoy revenues. Without those additions, General Fund-State revenue would have grown by only 6.1 percent in the 2003-05 Biennium.

Based on the November revenue forecast, Washington will have an estimated reserve of \$543.8 million by the end of the 2003-05 Biennium, up slightly from \$470.0 million in the previous biennium. These projected reserves assume no further changes in appropriations for the 2003-05 Biennium.

## **Major Initiatives**

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Led by Governor Gary Locke, the state of Washington in 2003 closed a challenging budget shortfall and laid the groundwork for continued fiscal discipline. The Governor's two-year, \$23 billion "Priorities of Government" General Fund budget focused on and funded programs and services most vital to citizens – ranging from public education to health care and economic development. The Governor also won passage of a 10-year, \$4.2 billion package to expand and repair Washington's crowded highway system and to improve the state's mass transportation facilities. The package is funded through new transportation taxes, primarily a five-cent increase in the gasoline tax. The Governor also made important strides to stimulate economic development, protect the environment, make state government more efficient, and improve health care for seniors and low-income citizens.

## **State Budget**

Facing a biennial budget shortfall that grew to \$2.6 billion, Governor Locke convinced the 2003 Washington Legislature to follow an innovative approach in order to balance the biennial General Fund budget, which pays for the vast majority of programs and services. With help from the private sector and cross-agency teams of state workers, the Governor proposed a \$23 billion budget based upon a transparent process to identify government services and programs most vital to citizens. Other programs, while popular, were cut back or eliminated. The Legislature embraced the approach and passed a bipartisan budget virtually identical to the Governor's proposal. The approach, called "Priorities of Government," has won national recognition for its effectiveness. The approach not only gave Washington citizens a clear understanding of what its government could afford, but laid the groundwork for priority based budgeting in the future.

## **Transportation**

Governor Locke worked with the Washington Legislature to achieve a bipartisan solution to strengthen transportation, the backbone of Washington's economy. The package authorizes spending nearly \$4.2 billion over 10 years to build and expand highway lanes and interchanges, make highways safer, get freight to market more quickly, and provide commuters with transit, rail, and other alternatives to driving. The funding package includes \$3.4 billion for highway and road projects; \$605 million to provide alternatives to driving alone including investments in transit, vanpools, passenger rail, and new ferry terminals that will have better connections to transit, commuter rail, and other transportation services; and \$100 million to preserve existing vessels and terminals, and to complete acquisition of four new auto ferries. The package is funded with a gas tax increase of 5 cents per gallon to a total of 28 cents per gallon, trucking fee increases of 15 percent, and a 0.3 percent sales tax surcharge added to motor vehicles.

## **Economic Development**

Amid a difficult economic period, the Governor and Legislature agreed on several important steps to spur economic development in Washington beyond an improved transportation system. These ranged from regulatory reform through creation of an Office of Regulatory Assistance to help cut red tape, to a large tax incentive package to the Boeing Company provisioned on whether it chooses to build next generation aircraft in Washington. Other economic development steps included tax incentives to retain and expand semiconductor manufacturing and to encourage development of bio-diesel and alcohol fuel development, and \$2.57 billion in capital construction funding to create thousands of family wage jobs immediately and build badly needed facilities for colleges, universities, and prisons to meet growing demand. Steps also included new laws to reduce the cost of unemployment insurance for employers, to reduce regulatory conflicts over water rights and water management, and to give growing cities, towns, and agriculture more certainty regarding water supplies.

## **Education**

The Governor and Legislature continued their commitment to education, providing \$10.6 billion for education services for one million public school students, including basic education programs, special education, school-bus transportation, levy equalization, bilingual education, and help for schools where students are challenged by poverty. The Governor and Legislature also continued to recognize higher education's role in strengthening the state economy. Spending including \$535 million in construction that builds for the future by addressing overcrowded classrooms at community colleges and investing in major projects at four-year institutions. The capital budget for state colleges and universities is \$238 million higher than expected because of an innovative plan to bond a portion of state lottery revenue. In addition, the budget provides funding to pay for scholarships for top-performing high school students, and to increase enrollment by 1,550 students in high-demand fields such as health care, computer science, math, and special education.

## **Environment**

Along with substantial funding to continue Washington's campaign to protect wild salmon runs, the Legislature and Governor provided additional tools to better ensure sufficient water quality and quantity to meet growing human demand. The year also saw passage of a program to safely dispose of and reduce mercury in the environment, along with tax incentives for bio-diesel fuel, and permanent funding for a rescue tug to protect against oil spills in the Strait of Juan de Fuca.

## **Health**

Despite difficult budget choices, the Governor and Legislature provided health care for more than a million children and needy adults. In addition, they approved programs to help elders and people with disabilities buy prescription drugs at more affordable prices, and took steps to reduce the overall cost of state-purchased drugs.

## **Digital Government**

Washington continued to make important strides to better serve citizens and businesses while reducing government costs through use of the Internet. Among successes in 2003, the Washington Department of Licensing surpassed its one-millionth online transaction in just two-and-a-half years. Citizens can renew car tabs online, and companies can apply for and renew business licenses. Among other services now on line include the ability to check the background of and disciplinary actions against health care providers, the ability of parents to make child support payments electronically, the ability to reserve a campsite at a state park, and continued improvements in the ability of businesses to pay their taxes electronically.

## **Looking Ahead**

In his final year of eight years at the helm, Governor Locke intends to push for better-financed public school and higher education systems. He and the Legislature, still struggling with a lackluster economy, will work together to continue identifying and funding priorities within available revenue, building a foundation for continued fiscal discipline in the years to come.

Steps to accommodate economic development will again be a priority, as will measures to protect Washington's most vulnerable adults and children. Also on the agenda are more measures to use Washington's water wisely in order to meet the needs of a growing population.

## **Financial Management Information**

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### **Internal Controls**

The state is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the state are protected from loss, theft, or misuse, and to ensure that adequate accounting data is compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. Internal controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

Washington State continues to assess the adequacy of its internal control structure and make improvements where weaknesses are found. These actions will help assure that the state maintains public accountability for years to come.

### **Budgetary Controls**

Budgetary control is maintained through legislative appropriations and the executive branch allotment process. The Governor is required to submit a biennial budget to the Legislature. The budget is legally required to be adopted through passage of appropriation bills by the Legislature

with approval by the Governor. Appropriated funds are controlled by the executive branch through an allotment process. This expenditure plan details the appropriation into monthly estimates by program, source of funds, and object of expenditure. Nonappropriated governmental funds are also subject to allotment control by the executive branch. Additionally, the state maintains an encumbrance accounting system as one technique of accomplishing budgetary control. Encumbered amounts lapse at the end of the appropriation. However, capital encumbrances are generally reappropriated as part of the following biennial budget.

The state's budgetary policies and procedures, fund accounting structure, and basis of accounting are explained in detail in the notes to the financial statements and notes to the required supplementary information.

### **Retirement Plans**

The state administers twelve defined benefit retirement plans, three combination defined benefit/defined contribution retirement plans, and one defined contribution retirement plan covering eligible employees of the state and local governments. Note 11 to the financial statements presents plan descriptions, information on funding policies, and combining statements of plan net assets and changes in plan net assets.

### **Insurance Activities**

The state has three insurance programs operated and accounted for as insurance businesses. Notes 1.L and 7.C to the financial statements disclose the specific programs and claims liability changes during Fiscal Year 2003 for each insurance program.

Liabilities of the workers' compensation insurance activity amount to \$15.9 billion as of June 30, 2003. The liability includes \$7.9 billion for supplemental pension cost of living adjustments (COLA) that, by statute, is not to be fully funded. This COLA is funded on a pay-as-you-go basis, and the Department of Labor and Industries' actuaries have indicated that future premium payments will be sufficient to pay these claims as they come due. The remaining \$8.0 billion in claims liability is fully funded by long-term investments, net of obligations under securities lending agreements, held for payment of claims.

The risk management insurance activity liabilities amount to \$498.9 million as of June 30, 2003. The funding for this liability is limited by statute to a maximum of 50 percent. This liability is currently funded by \$14.3 million in cash and pooled investments.

Health insurance activities have liabilities as of June 30, 2003, amounting to \$47.9 million that are fully funded with cash and investments, net of obligations under securities lending agreements.

### **Other Information**

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#### **Independent Audit**

State statutes require an annual audit by the Office of the State Auditor. The State Auditor is an independently elected public official. The state is also required to undergo an annual single audit in conformity with the provisions of the Single Audit Act of 1984 and U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

The State Auditor conducts the audit of all state agencies. In addition to meeting the requirements set forth in state statutes, the audit is also designed to meet the requirements of the federal Single Audit Act. The Auditor's report on the basic financial statements is included in the financial



section of this report. The Auditor's report related to the single audit, including the schedule of federal financial assistance, findings and recommendations, and reports on internal control structure and compliance with applicable laws and regulations, will be published in a separate report. When completed, the report will be available on the Office of Financial Management website at: <http://www.ofm.wa.gov>.

### **Awards**

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to Washington State for its Comprehensive Annual Financial Report for the fiscal year that ended June 30, 2002. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized Comprehensive Annual Financial Report, with contents conforming to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. Washington State has received a Certificate of Achievement for the last sixteen years. The Office of Financial Management considers this report to be in conformance with the Certificate of Achievement Program requirements, and will submit it to the GFOA.

### **Acknowledgment**

The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each state agency and institution of higher education, and the Office of Financial Management.

This Comprehensive Annual Financial Report reflects the commitment of the Governor to the Legislature, the citizens of Washington State, and the financial community to maintain financial statements in conformance with the highest standards of financial accountability.

Sincerely,

A handwritten signature in black ink that reads "Marty Brown". The signature is written in a cursive, flowing style.

Marty Brown  
Director

